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SUBJECT: INVESTMENT CLIMATE STATEMENT, 2008 - SRI LANKA

REF: 2007 STATE 158802

11. Per reftel, below is the investment climate statement for Sri Lanka for 2008.

[Begin text:]  
INVESTMENT CLIMATE STATEMENT-SRI LANKA  
JANUARY 2008

OPENNESS TO FOREIGN INVESTMENT

--Unpredictability Impedes Investment

Sri Lanka's intractable civil war, erratic policy environment, and cumbersome bureaucracy make it an unpredictable investment destination. However, compared to other South Asian countries, Sri Lanka is relatively open to foreign investment. It offers a relatively open financial system, moderately good infrastructure, and generally capable workers. Some U.S. and other foreign investors have realized worthwhile returns on investment in Sri Lanka; others have tried and come away frustrated.

Sri Lanka is a lower-middle income developing nation with a gross domestic product of about \$32 billion in 2007. This translates into a per capita income of \$1,475. Despite the resumption of the civil war, Sri Lanka's gross domestic product (GDP) grew by an estimated 6.7% in 2007. Growth was led by telecommunications, ports, construction and manufacturing exports. Growth in 2006 and 2007 came at the cost of 15-20% inflation, which eroded domestic purchasing power. The government predicts GDP growth of 7.0% and 10-15% inflation in 2008.

The Sri Lankan economy is remarkable for its resilience. Although suffering a brutal civil war that began in 1983, Sri Lanka has seen GDP growth average around 5% in the last ten years. Following a ceasefire in 2002 and subsequent economic reforms, the economy grew by about 5.7% in 2003-2004. Even the December 2004 Indian Ocean tsunami -- which killed 32,000 people, displaced 443,000, and caused

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an estimated \$1 billion in damage -- failed to dent GDP growth, which was 6% in 2005 and 7.4% in 2006; this was due in part to the

damage having been offset by reconstruction. Sri Lanka is a stable parliamentary democracy. In 1978, it shifted away from a socialist orientation and opened to foreign investment. However, changes in government have often been accompanied by reversals in economic policy. Of the two major parties, the more pro-business United National Party has been in opposition in recent years. When it last held power, from 2002 to 2004, it pursued privatization and regulatory reform welcomed by domestic and foreign investors. Currently, the ruling Sri Lanka Freedom Party has a more statist economic approach, guided by President Rajapaksa's 2005 election manifesto Mahinda Chintana ("Mahinda's Thoughts"). Mahinda Chintana seeks to reduce poverty by steering investment to disadvantaged areas; developing small and medium enterprises; promoting agriculture; and expanding the already enormous civil service. The Rajapaksa government has halted most privatization and advocates permanent state control of what it deems "strategic" enterprises such as state-owned banks, airports, and electrical utilities. The government has increased direct and indirect taxation to fund increased government expenditure. Sri Lanka's Board of Investment (BOI) is authorized to manage a number of export processing zones which feature business-friendly regulations and improved infrastructure for foreign investors. BOI incentives are attractive and real, but the BOI is not the "one stop shop" it aspires to be. Sri Lanka's large, inefficient, and dated bureaucracy often works at cross-purposes with BOI authorities and commitments. Additionally, major investments in Sri Lanka, such as infrastructure projects, require approval from the full cabinet, a process which is not transparent and which can politicize even the most needed investments. Registration of foreign company branch offices in Sri Lanka can be cumbersome as well.

The 24-year ethnic conflict between the U.S.-designated terrorist organization Liberation Tigers of Tamil Eelam (LTTE) and the Government of Sri Lanka has been a serious impediment to foreign investment. A Norwegian-brokered ceasefire between the LTTE and the

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government, in effect since February 23, 2002, broke down in 2006 and was formally abrogated by the government in early 2008. Resolution of the conflict appears unlikely in the near future.

Other impediments to investment in Sri Lanka are workers' declining English language skills, inflexible labor laws, overburdened infrastructure, and its unreliable court system. Sri Lanka boasts a 90% literacy rate in the local Sinhala and Tamil languages, but English, which was once widely spoken, is now far less prevalent. Sri Lanka's labor laws include many model protections, but can make it nearly impossible for companies to lay off workers even when market conditions fully warrant doing so. Sri Lanka has not invested in infrastructure to keep pace with its growth. Its roads are narrow and congested. Its electricity supply is generally reliable but can fail to meet peak demand in years of low rainfall. Delays in commissioning new power plants could make installed power inadequate to meet demand within four years. Sri Lanka's courts cannot be relied upon to uphold the sanctity of contracts. The courts are not practical for resolving disputes or obtaining remediation, because their procedures make it possible for one side in a dispute to prolong cases indefinitely. Aggrieved investors (especially those dealing with the government of Sri Lanka on projects) have frequently pursued out-of-court settlements, in hopes of speedier resolution.

#### --Major Sectors

The service sector is the largest component of GDP at 56%. In 2007 the service sector continued its strong expansion, fueled primarily by strong growth in telecommunications, ports, trading and financial services. Public administration and defense expenditures increased sharply in 2007. There also is a growing information technology sector, especially information technology training and software development and exports. There are about 6,000 people employed in export-oriented software development. Sri Lanka has seen some investment in the business process outsourcing (BPO) sector, which currently employs 5,500 to 6,000 people and has potential to grow further. Tourism remains well below potential due to resumed ethnic conflict.

Manufacturing accounts for about 16% of GDP. The textile, apparel, and leather products sector is the largest, accounting for 39% of

total industrial output. The second-largest industrial sector, at 22% of total manufacturing output, is food, beverages, and tobacco. The third-largest industrial sector is chemical, petroleum, rubber, and plastic products. The construction sector accounts for 7% of GDP and posted strong growth rates in 2006-7, largely due to demand for tsunami reconstruction projects. Mining and quarrying account for

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2% of GDP.

Agriculture has lost its relative importance to the Sri Lankan economy in recent decades. It employs 32% of the working population, but accounts for only 17% of GDP. Rice, the staple cereal, is cultivated extensively. The plantation sector consists of tea, rubber, and coconut; in recent years, the tea crop has made significant contributions to export earnings, and increasing global demand for natural rubber augers well for that sector.

--Trade

According to preliminary data for 2007, Sri Lanka's exports (mainly apparel, tea, rubber, gems and jewelry) were \$7.5 billion and imports (mainly oil, textiles, food, and machinery) were \$11.2 billion. Apparel is a vital industry accounting for about 45% of exports. Although garment exports face increased competition following the 2005 expiration of the worldwide Multifiber Arrangement, exports increased by 6% in 2006 and 10% in the first 10 months of 2007. This growth was supported by duty free access to the EU through the EU GSP+ scheme and by U.S. and EU safeguards on exports from China. Apparel exporters expect tougher competition once restrictions on Chinese apparel exports are lifted in 2008. Sri Lanka's apparel industry is undertaking various efforts to meet increasing global competition, including the establishment of fabric mills and accessory manufacturing factories. The industry has also embarked on a branding campaign under the slogan of "Garments without Guilt" to highlight the industry's adherence to relatively high labor standards, its prohibition of child labor, and its active corporate social responsibility culture. Tea, Sri Lanka's second largest export, attracted premium prices in 2007. Nevertheless, the tea industry is challenged by a shortage of plantation labor, demand for higher wages, and growing competition.

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Exports to the United States, Sri Lanka's most important market, were \$2.1 billion in 2006, or 31% of total exports. For many years, the United States has been Sri Lanka's biggest market for garments, taking about 56% of total garment exports. India is Sri Lanka's largest supplier, with exports of \$2.2 billion in 2006. The United States exported approximately \$200 million to Sri Lanka in 2006 consisting primarily of industrial machinery, as well as medical instruments, paper, specialized fabrics and textiles for use in the garment industry, and pharmaceuticals.

--Board of Investment

The Board of Investment (BOI) ([www.boi.lk](http://www.boi.lk)), an autonomous statutory agency, is the primary government authority responsible for investment, with a focus on foreign investment. The BOI acts as a facilitator for investment. It is intended to provide "one-stop" service for foreign investors, with duties including approving projects, granting incentives, and arranging services such as water, power, waste treatment and telecommunications. The BOI is relatively effective in assisting investors who want to establish operations within its industrial processing zones; it is less effective in facilitating and service large investments outside these zones. It also assists people in obtaining resident visas for expatriate personnel and facilitates import and export clearances. The Public-Private Partnership Unit, a new division of BOI, has responsibility for coordinating all public-private infrastructure projects.

Although there are appearances that the BOI has been used for political purposes upon occasion, generally the treatment given to foreign investors is non-discriminatory. In fact, some local companies have complained that they are discriminated against, as qualifying foreign investors can benefit from a range of advantages.

However, even with incentives and BOI facilitation, foreign investors face difficulties operating in Sri Lanka. Problems range from difficulty clearing equipment and supplies through customs speedily to difficulty obtaining a factory site. Legal challenges

to environmentally sensitive projects have been burdensome, even when objections are unfounded. Slow and indecisive application of bureaucratic requirements has also obstructed investment. Several high profile and needed infrastructure projects have dried up in the past two years, as investors tired of waiting for approval and action. In part to avoid these delays, and to overcome land allocation problems, the BOI encourages investors to locate their operations in BOI-established industrial processing zones. Investors locating in industrial zones also get access to relatively better infrastructure facilities such as reliable power, telecommunication and water supplies.

#### --Laws Affecting Investment

The principal law governing foreign investment is Law No. 4, created in 1978 (known as the BOI Act), as amended in 1980, 1983 and 1992, along with implementation regulations established under the Act. The BOI Act provides for two types of investment approvals. Under section 17 of the Act, the BOI is empowered to grant concessions (see details below) to companies satisfying certain eligibility criteria on minimum investment, exports and in some cases employment. Investment approval under Section 16 of the act permits entry for foreign investment to operate under the "normal" laws of the country and applies to investments that do not satisfy eligibility criteria for BOI incentives. Other laws affecting foreign investment are the Securities and Exchange Commission Act of 1987 as amended in 1991 and 2003, and the Takeovers and Mergers Code of 1995 revised in 2003. A new Companies Act came into effect in 2007 replacing the Companies Act of 1982. The new law aims to improve trade and commerce as well as corporate governance in the business sector. It features simplified regulations concerning company formation; provisions specifying the duties of company directors; provisions to prevent the abuse of powers by directors; provisions to protect creditors; and a dispute board to settle disputes among directors. Various labor laws and regulations also affect investors. See sections below.

#### --Foreign Equity Shares by Sector

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The government allows 100% foreign investment in the following services: banking, finance, insurance, stock-brokering, construction of residential buildings and roads, supply of water, mass transportation, telecommunications and information technology (software development and business process outsourcing), energy production and distribution, professional services, and the establishment of liaison offices or local branches of foreign companies. These services are regulated and subject to approval by various government agencies. The screening mechanism is non-discriminatory and, for the most part, routine.

Investment in other sectors is restricted and subject to screening and approval on a case-by-case basis when foreign equity exceeds 49%. The affected sectors are: shipping and travel agencies; freight forwarding; fishing; timber-based industries; growing and primary processing of tea, rubber, coconut, rice, cocoa, sugar and spices; and the production for export of goods subject to international quota. Foreign investment restrictions and government regulations also apply to international air transport; coastal shipping; lotteries; large-scale mechanized gem mining; and sensitive industries such as military hardware, dangerous drugs and currency.

Foreign investment is not permitted in the following businesses: non-bank money lending; pawn-brokering; retail trade with a capital investment of less than \$1 million (with one notable exception: the BOI permits retail and wholesale trading by reputed international brand names and franchises with an initial investment of not less than \$150,000); coastal fishing; and the awarding of local university degrees. Foreign degree courses can be offered in Sri Lanka by affiliating with foreign universities. However, there is no scheme to monitor the quality assurance or accreditation of the foreign courses offered in Sri Lanka.

#### --Privatization Halted

The current Government has halted most privatization. Government treatment of foreign investors in past privatization processes has been largely non-discriminatory. In 2003, however, the government sold part of the retail operations of state-owned Ceylon Petroleum Corporation to Indian Oil Corporation without a formal tender process.

Labor unions in state-owned enterprises are often opposed to privatization and restructuring and seem particularly averse to foreign ownership. In the past, this made the privatization of government entities problematic for new foreign owners.

#### CONVERSION AND TRANSFER POLICIES

In accordance with its Article VIII obligations as a member of the International Monetary Fund (<http://www.imf.org/external/pubs/ft/aa/aa08.htm>), Sri Lanka has liberalized exchange controls on current account transactions. In times of balance of payments difficulties the government tends to impose controls on foreign exchange transactions. Most recently, in October 2006, the Central Bank required importers to keep a 50% deposit on letters of credit on non-essential imports. The requirement was removed in March 2007.

There are no surrender requirements on export receipts, but exporters need to repatriate export proceeds within 120 days to settle export credit facilities. Other export proceeds can be retained abroad. Currently, contracts for forward bookings of foreign exchange are permitted for a maximum period of 360 days for the purposes of payments in trade and 720 days for the repayment of loans.

There are no barriers, legal or otherwise, to the expeditious remitting of corporate profits and dividends for foreign enterprises doing business in Sri Lanka. Remittance of business fees (management fees, royalties and licensing fees) is also freely permitted for companies with majority foreign investment approved under Section 17 of the BOI Act. Other companies require Central Bank approval. Repatriation of funds for debt service and capital gains of companies exempted by the BOI from exchange control

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regulations is permitted. Other foreign companies remitting funds for debt service and capital gains require Central Bank approval. The average delay period for remitting investment returns such as dividends, return of capital, interest and principal on private foreign debt, lease payments, royalties and management fees through normal, legal channels is in the range of 1 to 4 weeks. All stock market investments can be remitted without prior approval of the Central Bank through a special bank account. Investment returns can be remitted in any convertible currency at the legal market rate. While controls on capital account (investment) transactions usually prohibit foreigners from investing in Sri Lankan debt and fixed income securities, the government allows limited access to foreigners to invest in government rupee bonds. The Central Bank's dollar denominated bond issues in the local market are also open to foreign investors. Local companies require Central Bank approval to invest abroad. The process of granting approval for such investments was streamlined in 2002, resulting in a substantial increase in approvals.

#### EXPROPRIATION AND COMPENSATION

Since economic liberalization policies began in 1978, the Sri Lankan Government has not expropriated a foreign investment. The last expropriation dispute was resolved in 1998.

#### DISPUTE SETTLEMENT

##### --Legal System

Sri Lanka's legal system reflects diverse cultural influences. Criminal law is fundamentally British. Basic civil law is Roman-Dutch. Laws pertaining to marriage, divorce, and inheritance are communal. Sri Lankan commercial law is almost entirely statutory. The law was codified before independence in 1948 and

reflects the letter and spirit of British law of that era. Its amendments have, by and large, kept pace with subsequent legal changes in the U.K. Several important legislative enactments regulate commercial matters: the Board of Investment Law, the Intellectual Property Act, the Companies Act, the Securities and Exchange Commission Act, the Banking Act, the Industrial Promotion Act and Consumer Affairs Authority Act. Most of these laws were revised recently.

Sri Lanka's court system consists of the Supreme Court, the Court of Appeal, Provincial High Courts and the Courts of First Instance viz. district courts (with general civil jurisdiction) and magistrate courts (with criminal jurisdiction). The provincial high courts have original, appellate and reversionary criminal jurisdiction. The Court of Appeal sits as the intermediate appellate court with a limited right of appeal to the Supreme Court. The Supreme Court exercises final appellate jurisdiction for all criminal and civil cases.

All commercial matters exceeding the value of Rs 3 million (approximately \$28,000) fall within the jurisdiction of the Commercial High Court of Colombo. There are also a number of tribunals which exercise judicial functions, such as the Labor Tribunals to hear cases brought by workers against their employers. Until recently, the court system was largely free from government interference. There are allegations that the judiciary is sometimes subject to political influence, but this has not been evident in commercial litigation so far. Litigation can be slow and unproductive, though. Monetary judgments are usually made in local currency. Procedures exist for enforcing foreign judgments.

#### --Bankruptcy Laws

The Companies Act and the Insolvency Ordinance provide for dissolution of insolvent companies, but there is no mechanism to facilitate the re-organization of financially-troubled companies. Other laws make it difficult to keep a struggling company solvent. The Termination of Employment of Workmen Act, for example, prohibits employers from dismissing workers even on the grounds of inefficiency. The Termination Act was recently revised to facilitate downsizing. Under the revised act, a compensation

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formula for laid-off workers has been published. But employers have protested that it is excessive compared to similar formulae in the Asian region, with terms in Sri Lanka about twice as generous as the East Asian average. (Please see section on "Labor" for details.)

In the absence of proper bankruptcy laws, extra-judicial powers granted by law to financial institutions protect the rights of creditors. When a company cannot meet the demands of a creditor for a sum exceeding Rs 50,000, (approximately \$500) the creditor may petition for company to be dissolved by the court. Lenders are also able to enforce financial contracts through powers that allow them to foreclose on loan collateral without the intervention of courts. However, loans below Rs 5 million (\$460,000) are exempt from the application of the law. Additionally, a recent judgment ruled that these powers would not apply with respect to collateral provided by guarantors to a loan. These two moves have weakened creditors' rights. Financial institutions also face other legal challenges as defaulters obtain restraining orders on frivolous grounds due to technical defects in the recovery laws. Also, for default cases filed in courts, the judicial process is extremely slow.

The new Companies Act of 2007 introduced a "solvency test" to determine the financial health of a company. There are provisions relating to duty of a company's directors on serious loss of capital. The solvency test is intended to prevent companies without sufficient assets from obtaining loans and to protect rights of creditors.

The Companies Act does not provide for the revival of struggling companies. However, as in the past, it is expected that the courts would take a liberal attitude towards any restructuring plans that may be of benefit to a company.

## --Investment Protection

In principle, foreign investments are guaranteed protection by the Constitution of Sri Lanka. The government has entered into 24 investment protection agreements with foreign governments (including the United States) and is a founding member of the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. Under Article 157 of the Constitution of Sri Lanka, investment protection agreements enjoy the force of law and no legislative, executive or administrative action can be taken to contravene them. The government has ratified the Convention on Settlement of Investment Disputes, which provides the mechanism and facilities for international arbitration through the World Bank's International Center for the Settlement of Investment Disputes (ICSID).

The U.S.-Sri Lanka Bilateral Investment Treaty (BIT) was ratified by both governments in 1993  
([www.state.gov/documents/organization/43588.pdf](http://www.state.gov/documents/organization/43588.pdf)).

## --Arbitration

The Arbitration Act of 1995 gives recognition to the New York Convention on recognition and enforcement of foreign arbitral awards. Arbitral awards made abroad are now enforceable in Sri Lanka. Similarly, awards made in Sri Lanka are enforceable abroad. A center for arbitration known as the Institute for the Development of Commercial Law and Practice (ICLP) ([www.iclp-arbitrationcentre.com](http://www.iclp-arbitrationcentre.com)) has been established in Colombo for the expeditious, economical, and private settlement of commercial disputes. However, the ICLP appears unlikely to become involved in disputes involving the Sri Lankan Government, which is often a party to disputes involving foreign investors.

Sri Lanka's first commercial mediation center was established in 2000 and became operational in mid 2001. Commercial mediation is conducted under the Commercial Mediation Act. Interest in mediation is still low.

The Labor Department has a process involving labor tribunals for settling industrial disputes with laborers or unions, and arbitration is required when attempts to reconcile industrial disputes fail. The Labor Commissioner typically becomes involved in

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labor-management mediation. Other senior officials, including the Labor Minister, and the President, have intervened in particularly difficult cases.

The government record in handling investment disputes is problematic. Disputes often become politicized, causing the government to put political interests ahead of its respect for the sanctity of contracts. For example, in 2006, Indian Oil Corporation's petroleum retailing subsidiary in Sri Lanka temporarily closed its operations when the government failed to honor its commitment to reimburse the company for fuel sold at the government-controlled price.

## --Investment Disputes Involving U.S. Companies

U.S. companies have experienced problems with payment of valid contracts; implementation of agreements with the government; and inexplicable failure to secure contracts, despite demonstrated superior performance, high value, and competitive bids.

A U.S. power company producing electricity in Colombo has been unable to obtain payment since 2004 for power that it produced under a temporary, more costly, operating mode following a fire in its plant. The company had intended to suspend operations to conduct repairs following the fire, but agreed to the government's request that it keep producing power even at a higher cost. However, the government has withheld payment on the basis of a questionable Attorney General finding that the higher than usual electricity price was imposed on the government "under duress."

In 2000, the Sri Lankan Supreme Court effectively blocked an investment agreement between the Government of Sri Lanka and a U.S.

mining company. Although the agreement was already initialed and approved by the Sri Lankan cabinet, work on the project had not yet begun. A group of citizens filed a fundamental rights case under a Sri Lankan law that allows any person to seek Supreme Court protection if a government or administrative act impedes their rights. In this case, the plaintiffs alleged that their rights would be violated if the project was implemented, and the court upheld their complaint. Without any technical argument, a partial bench of three judges ruled that the project could not proceed before completion of a new series of comprehensive and expensive studies, some of which appeared to be technically impractical. The Supreme Court decision has never been reversed.

## PERFORMANCE REQUIREMENTS AND INCENTIVES

### --Performance Requirements

The Board of Investment specifies certain minimum investment amounts for both local and foreign investors to qualify for incentives. Firms enjoying preferential incentives in the manufacturing sector in most cases are required to export 80% of production, while those in the service sector must export at least 70% of production. Sri Lanka complies with WTO Trade Related Investment Measures (TRIMS) obligations.

Sri Lanka encourages foreign investment in information technology, electronics assembly, light engineering, automobile parts and accessories manufacturing, industrial and information technology parks, rubber based industries, information and communication services, tourism and leisure related activities, agriculture and agro processing, port-related services, regional operating headquarters, and infrastructure projects. Foreign investors are generally not expected to reduce their equity over time, nor are they expected to transfer technology within a specified period of time, except for build-own-transfer or other such projects in which the terms are specified within pertinent contracts.

In some BOI-approved enterprises, businesses are required to maintain certain levels of employment to enjoy incentives. In addition, privatization agreements generally prohibit new owners from dismissing workers, although the owners are free to offer voluntary retirement packages to reduce their workforce. Some foreign investors have received political pressure to hire workers

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from a particular constituency or a given list, but have successfully resisted such pressure with no apparent adverse effects.

Foreign investors who remit at least \$250,000 can qualify for a one-year resident visa, which can be renewed. Employment of foreign personnel is permitted when there is a demonstrated shortage of qualified local labor. Technical and managerial personnel are in short supply, and this shortage is likely to continue in the near future. Foreign employees attached to BOI-approved companies usually receive preferential tax treatment for an initial period and do not experience significant problems in obtaining work or residence permits.

### --Investment Incentives

The Board of Investment ([www.boi.lk](http://www.boi.lk)) has various incentives, with such investments typically requiring prior approval by various ministries. Please see the note at the end of this section on proposed changes to the incentive programs listed:

#### Incentive Program I:

##### Qualifying industries:

- Non-traditional manufacturing exports and companies supplying to exporting companies. Minimum investment of \$500,000(a);
- Export oriented services. Minimum investment of \$500,000;
- Manufacture of industrial tools and/or machinery. Minimum investment of \$500,000;
- Small-scale infrastructure. Minimum investment of \$500,000;



- Research and development. Minimum investment of \$100,000;
- Agriculture and agro processing industries. Minimum investment of \$150,000;
- Export trading houses of rural sector. Minimum investment of \$150,000

Incentives: Currently, the above industries qualify for a five-year tax holiday. A preferential tax of 10% in the 6th and 7th years follows the tax holiday for some industries. Some of these industries qualify for duty-free imports (generally, during the life of the project for export-oriented projects, and during the project implementation period for others). Exporting companies and export-oriented services will be exempted from exchange control regulations. They will also qualify for free repatriation of profits and dividends and free transferability of shares. A two-year tax holiday is available for investments with an investment less than \$500,000. A recently introduced Economic Service Charge (ESC) at 0.25% of income applies to BOI-approved companies with tax holidays. The tax applies even to existing companies -- there is no grandfather clause. ESC will apply to BOI approved manufacturing companies from the fourth year of operation.

#### Incentive Program II:

##### Qualifying Industries:

- Information technology (IT) or information technology enabled services. Minimum investment of \$150,000. Minimum employment levels apply;
- Information technology training institutes. Minimum number of students applies;
- Business Process Outsourcing (BPO). Minimum investment of \$150,000. Minimum employment levels apply;
- Regional operating headquarters providing the following services to related businesses outside Sri Lanka: administration, business planning, sourcing raw materials, research and Development, technical support, financial and treasury management, marketing and sales promotion. Minimum investment of \$250,000.

Incentives: Currently, IT services, IT training institutes, and BPO firms qualify for tax holidays of 5-12 years provided they meet minimum employment and student levels. Otherwise, a preferential tax of 10% applies for 2 years. Regional operating headquarters qualify for a tax holiday of 3 years. A preferential tax of 10% will apply in the 4th and 5th years. From the 6th year onwards, a

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preferential tax of 15% will apply. Capital goods for these projects will be exempted from import duty for above investments. A recently introduced Economic Service Charge at 0.25% of income applies to BOI-approved companies enjoying tax holidays, from the fourth year of operation. The new tax applies even to those companies already operating in Sri Lanka.

#### Incentives for Regional Development:

The BOI has a separate incentive program to promote regional development, with the aim of establishing new factories or service companies (such as hotels, hospitals, or training institutes) in the regions outside the capital Colombo. The incentives include 10-20 year tax holidays for investments in northern and eastern provinces and 2-10 year tax holidays for investments located in other provinces. In addition, imports of machinery and equipment are exempted from both customs duty and the value-added tax. Minimum investment levels apply.

#### Incentives for Infrastructure Development:

Companies acquiring existing companies in petroleum, power generation, transmission, development of highways, seaports, airports, railways, water services, public transport, agriculture and agro processing and other infrastructure projects approved by the BOI will qualify for tax holidays ranging from 5 to 8 years depending on the magnitude of investment. A preferential tax of 15% will follow after the tax holiday period. These companies will also qualify for duty free imports of capital goods. A minimum investment of \$12.5 million is required.

Large-scale new infrastructure projects in power generation, transmission and distribution; development of highways, seaports, airports, public transport and water services; establishment of industrial parks, and other infrastructure projects approved by the BOI will qualify for tax holidays ranging from 3 to 15 years depending on the size of the investment. A preferential tax of 15% will follow the tax holiday. They will also qualify for duty free imports of capital goods. A minimum investment of \$12.5 million is required.

#### Incentives for Other Investments:

- Industrial estates. Minimum investment of \$500,000 to \$10 million; tax holidays ranging from 3 to 15 years;
- Textile fabric manufacturing, processing. Minimum investment of \$500,000 to \$10 million; tax holidays ranging from 5 to 15 years.

Note: The Government has proposed to reduce all tax holidays listed above to 3 years other than the tax holidays offered under regional development program (to be revised to 5 years) and large infrastructure projects of national importance. It is not known when this revised incentive scheme will be implemented.

For further information on investment incentives and other investment-related issues, potential investors are encouraged to contact the Board of Investment directly. The BOI can be found at [www.boi.lk](http://www.boi.lk), or reached via e-mail at [info@boi.lk](mailto:info@boi.lk). The BOI has introduced an investor matchmaking service via the BOI website. Information regarding this service can be found at [www.boi.lk/partnership](http://www.boi.lk/partnership).

#### --Trade Agreements Enhance Market Access to South Asia and Europe

A preferential trade agreement, the Indo-Lanka Free Trade Agreement (ILFTA) ([www.doc.gov.lk](http://www.doc.gov.lk)) between Sri Lanka and India, is now in effect. Under this agreement, most products manufactured in Sri Lanka with at least 35% domestic value addition (if raw materials are imported from India, domestic value addition required is only 25%), qualify for duty free entry to the Indian market. Tariff concessions for Sri Lankan products include zero tariffs on 4,235 items; 50 to 100% reduction for tea and garments under quota; 25% reduction for 553 textile items; and no reduction for 431 items on India's "negative list." Discussions are underway to reduce the negative lists of both countries. The two countries are also

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discussing services sector liberalization, under a proposed Comprehensive Economic Partnership Agreement (CEPA). Other areas potentially covered by the CEPA are investment and economic cooperation. Because production constitutes a portion of value addition, ILFTA and the proposed CEPA enables foreign firms operating in Sri Lanka to gain preferential entry into the Indian market.

Some U.S. companies currently avail themselves of the ILFTA by adding at least 35% value in Sri Lanka and getting import duties into India reduced from as much as 15% to as little as zero. The American Chamber of Commerce in Sri Lanka, in a study on the ILFTA, identified agro processing, food preparation, tea, rubber products, coconut products, spices, furniture, ceramic and confectionary as having growth potential in India. The study also found vehicles and vehicle parts, aircraft parts and motorcycles to be possible attractive sectors for U.S. manufacturers under the Indo-Lanka Agreement.

Sri Lanka's Board of Investment promotes the following product sectors under ILFTA: confectionary and cocoa products, rubber products, plastics, footwear, ceramics, jewelry, machinery and mechanical appliances, electronics and electrical products, automobiles and spare parts, medical instruments, furniture, and doors.

The 2005 Sri Lanka-Pakistan Free Trade Agreement (SLPKFTA) ([www.doc.gov.lk](http://www.doc.gov.lk)) provides Sri Lanka with duty-free entry into Pakistan for 206 items. Pakistan's negative list contains 541 items

with no duty concessions. Pakistan will phase out tariffs on the balance of approximately 4,000 items over a 3 year period, meaning Pakistan will offer duty free entry to almost all Sri Lankan exports by June 2008. Sri Lanka's Board of Investment promotes the following product sectors under SLPKFTA: rubber products, ceramics, machinery and mechanical appliances, electronics and electrical appliances, medical instruments, and automobiles and spare parts.

Sri Lanka and six other South Asian nations belonging to the South Asian Association for Regional Cooperation (SAARC) agreed in 2004 to establish a South Asian Free Trade Area (SAFTA) (<http://www.saarc-sec.org/main.php>), which began operation on July 1, 2006. SAFTA offers regionalized tariff reductions for imports from member countries. Stated goals of SAARC members under SAFTA are to reduce duties for imports from member countries to between zero and 5% over a period of 7-10 years.

These agreements help make Sri Lanka a gateway to South Asia for foreign investors.

Sri Lankan exports to the European Union (EU) are also duty free under the "GSP-Plus" incentive agreement, which came into force on July 1, 2005. Under this program, 7,200 Sri Lankan products meeting rules-of-origin criteria can enter the EU duty free.

#### RIGHT TO PRIVATE OWNERSHIP AND ESTABLISHMENT

Private entities are free to establish, acquire, and dispose of interests in business enterprises. Private enterprises enjoy benefits similar to those granted to public enterprises, and there are no known limitations to access to markets, credit, or licenses. Foreign ownership is allowed in most sectors. Private land ownership is limited to fifty acres per person. The government owns about 80% of the land in Sri Lanka, including the land housing most tea, rubber, and coconut plantations. The government has leased most of these plantations to the private sector on 50-year terms. Although state land for industrial use is usually allotted on a 50-year lease, 99-year leases may also be approved on a case-by-case basis, depending on the nature of the project.

While foreign investors can purchase land from private sellers, the government has imposed a 100% tax on land transfers to foreigners. For this purpose, Sri Lanka has defined foreign investment to involve as little as 25% foreign ownership - a definition that can be particularly difficult for companies listed on the Colombo Stock Exchange since on any particular day, their ownership

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characteristics may vary. Apartments above the third floor of condominium buildings, land for the development of large housing schemes, hospitals and hotels with a minimum investment of \$10 million, exporting companies with a minimum investment of \$1 million, and large infrastructure projects with a minimum investment of \$50 million are exempted from the tax. Regulations regarding these exceptions have been published in Gazette No 1386/18 dated March 30, 2005.

#### PROTECTION OF PROPERTY RIGHTS

##### --Property Rights

Secured interests in property are recognized and enforced. The legal system is nondiscriminatory and protects and facilitates acquisition and disposition of property rights by foreigners, although it has recently become subject to political influence. A fairly reliable registration system exists for recording private property including land, buildings and mortgages. However, there are problems due to fraud and forged documents. The Government has begun to address these issues under a World Bank-sponsored judicial reforms project.

##### --Intellectual Property Rights Protection

Sri Lanka is a party to major intellectual property agreements including the Berne Convention for the Protection of Literary and Artistic Works, the Paris Convention for the Protection of

Industrial Property, the Madrid Agreement for the Repression of False or Deceptive Indication of Source on Goods, the Nairobi Treaty, the Patent Co-operation Treaty, the Universal Copyright Convention, and the Convention establishing the World Intellectual Property Organization (WIPO). Sri Lanka and the United States in 1991 signed a Bilateral Agreement for the Protection of Intellectual Property Rights. Sri Lanka is also a party to the Trade Related Intellectual Property Rights (TRIPS) agreement in the World Trade Organization. Sri Lanka has not acceded to the WIPO Performances and Phonograms Treaty (WPPT); the WIPO Copyright Treaty (WCT); or the WTO Information Technology Agreement.

In November 2003, a new intellectual property law came into force that was intended to meet both U.S.-Sri Lanka bilateral IPR agreement and TRIPS obligations to a great extent. The law governs copyrights and related rights, industrial designs, patents, trademarks and service marks, trade names, layout designs of integrated circuits, geographical indications, unfair competition, databases, computer programs, and undisclosed information. All trademarks, designs, industrial designs and patents must be registered with the Director General of Intellectual Property. Sri Lanka recently introduced regulations to regulate the commercial use of local creations.

Infringement of intellectual property rights (IPR) is a punishable offense under the law. Intellectual property rights come under both criminal and civil jurisdiction. Recourse available to owners includes injunctive relief, seizure and destruction of infringing goods and plates or implements used for the making of infringing copies, and prohibition of imports and exports. Penalties for the first offence include a prison sentence of 6 months or a fine of up to Rs 500,000 (\$4,600), but smaller penalties are the norm. Penalties can be doubled for a second offense. Aggrieved parties can seek redress for any IPR violations through the courts, though this can be a frustrating and time-consuming process.

Since the passage of the 2003 IPR law Sri Lanka has slowly begun enforcing its provisions. The Police occasionally raid counterfeit CD/VCD stores as well as counterfeit garment sellers. However, it is rare for the police to act without a formal complaint and assistance from an aggrieved party. Several offenders have been charged or convicted by courts. But the minimal damages and suspended sentences imposed suggest that the court system still fail to recognize the significance of intellectual property rights.

Counterfeit goods continue to be widely available in Sri Lanka. Local agents of well-known U.S. and other international companies

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representing recording, software, movie, clothing and consumer product industries continue to complain that lack of IPR protection is damaging their businesses. Piracy of sound recordings and software is widespread, making it difficult for the legitimate industries to protect their market and realize their potential in Sri Lanka. Software companies complain of the lack of IPR enforcement within government institutions and even some larger corporations, including several banks. An IPR working group of adversely affected industries, led by the American Chamber of Commerce of Sri Lanka, is working to pursue more aggressive enforcement and enhance public awareness.

#### --Patents, Copyrights and Trademarks

Patents are valid for 20 years from the date of application but must be renewed annually. Patents are granted for inventions, with the following exceptions: discoveries, scientific theories and mathematical methods, plant or animal varieties (other than micro biological processes) and essential biological processes for the production of plants and animals (other than non-biological and microbiological processes), business rules and methods, methods of treatment by surgery or therapy, and diagnostic methods practiced on a human or animal body. The law also permits compulsory licensing and parallel imports of pharmaceutical products. Compulsory licensing will allow the government to grant licenses to manufacture certain patented drugs, overruling patent licenses in a national emergency. The parallel imports will allow the import of a branded

drug from an alternative source.

Copyrights are not registered. A work is protected automatically by operation of law. Original literary, artistic, and scientific works including computer programs and databases are protected under the new law. There are enforcement limitations applying to copyrights, including software.

Sri Lanka recognizes both trademarks and service marks. The exclusive right to a mark is acquired by registration. A mark may consist of words, slogans, designs, etc. Protection also is available to well known marks not registered in Sri Lanka. Registered trademarks are valid for ten years and renewable. The law also recognizes both certification marks and collective marks.

#### TRANSPARENCY OF REGULATORY SYSTEM

The Board of Investment strives to inform potential investors about laws and regulations that may affect operations in Sri Lanka. Laws are in place pertaining to tax, labor and labor standards, exchange controls, customs, environmental norms, and building and construction standards. However, some of the laws and regulations are difficult to access.

Foreign and domestic investors often complain that the regulatory system is unpredictable due to outdated regulations, rigid administrative procedures, and excessive leeway for bureaucratic discretion. Effective enforcement mechanisms are sometimes lacking, and coordination problems between the BOI and relevant line agencies frequently emerge. Lethargy and indifference on the part of mid- and lower-level public servants compound transparency problems. Lack of sufficient technical capacity within the government to review financial proposals for private infrastructure projects also creates problems during tendering. An example of weakness in regulations occurred in mid-2006, when police and government agencies closed two satellite television broadcasting stations for not possessing required licenses. The two stations remained closed for over five months, before various government agencies reauthorized their operations.

In 2005-2007, the Government awarded several key infrastructure projects to Chinese companies outside the tender process. They included a 300 megawatt coal power project, a fuel bunkering project, and a large port construction project in the Southern district of Hambantota. In addition, the Government has promised oil exploration rights to India and China outside the tender process.

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Although many foreign investors, including U.S. firms, have had positive experiences in Sri Lanka, some have encountered significant problems with government practices and regulations. Some multinational firms have experienced extensive unexplained delays in trying to reach agreement on investment projects. Others have had contracts arbitrarily canceled without compensation, even though the Sri Lankan Cabinet had approved those contracts.

Proposed laws and regulations are generally made available for public comment. However, occasionally they are published without public discussion.

#### EFFICIENT CAPITAL MARKETS AND PORTFOLIO INVESTMENT

##### --Availability of Financial Resources

Retained profits finance about 70% of private investment, with short term borrowing financing a further 20% of investment. The stock market and corporate securities market have not been significantly used to raise capital. Foreign direct investment (FDI) finances about 4% of overall investment. Foreign investors are allowed to access credit on the local market. They are also free to raise foreign currency loans.

The state consumes over 50% of the country's domestic financial resources and has a virtual monopoly on the management and use of

long-term savings in the country. This inhibits the free flow of financial resources to product and factor markets. For 2008, the government's net borrowing from the local market is forecast to be Rs 155 billion (\$1.3 billion). Due to high inflation and increased government borrowing, interest rates rose sharply towards the end of 2007.

#### --Credit Instruments

Commercial banks and two development finance institutions, the National Development Bank (NDB) and the Development Finance Corporation of Ceylon Bank (DFCC), are the principal source of bank finance. Bank loans are the most widely used credit instrument for the private sector. Financial institutions also raise syndicated bank loans to fund large-scale investment projects undertaken by the private sector.

The domestic debt market in Sri Lanka is still at a nascent stage. The first credit rating agency in Sri Lanka was Fitch Rating Lanka ([www.fitchratings.lk](http://www.fitchratings.lk)), which opened an office in Colombo in 1999. Fitch Ratings Lanka is joint venture between Fitch Ratings Inc, International Finance Corporation, (IFC), Central Bank of Sri Lanka, and several leading local financial institutions. Credit ratings are now mandatory for all deposit-taking institutions and for all varieties of debt instruments and have helped numerous Sri Lankan companies raise funds through debt markets.

Sri Lanka received its first sovereign credit ratings in December 2005, with a "BB-minus" from Fitch Ratings and a "B-Plus" from Standard and Poor's (S&P). These sub-investment grade ratings reflect the high level of government indebtedness and weak revenue mobilization, together with political and security concerns. The two agencies changed their rating outlook, but not the ratings, from stable to negative in April 2006 following escalating violence. The S&P rating outlook was revised to stable in September 2007. The Government borrowed \$500 million at an interest rate of 8.25% for five years in October 2007. This was Sri Lanka's first sovereign bond sale to international markets.

#### --Accounting Standards

There is an active and fairly competent accounting profession, based on the British model. The source of accounting standards is the Institute of Chartered Accountants of Sri Lanka (ICASL), and standards are constantly updated to reflect current international accounting and audit standards adopted by the International Accounting Standards Board (IASB). Due to the lack of an adequate enforcement mechanism, however, problems with the quality and reliability of financial statements still exist.

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Sri Lankan accounting standards are applicable for all banks, stock exchange listed companies and all other large and medium-sized companies in Sri Lanka. Accounts of such business enterprises are required to be audited by professionally qualified auditors holding ICASL membership. ICASL has published accounting standards for small companies as well. The Accounting Standards and Monitoring Board (ASMB) is responsible for monitoring compliance with Sri Lankan accounting and auditing standards. British professional accounting bodies are quite active in Sri Lanka. The Chartered Institute of Management Accountants (CIMA), a leading professional accounting body based in the UK and spread over the Commonwealth, has its largest overseas presence in Sri Lanka.

#### --Securities and Exchange Commission

The Securities and Exchange Commission (SEC) regulates the securities market in Sri Lanka. The SEC law was revised in 2003, enhancing the SEC's coverage and investigative powers. The SEC now covers stock exchanges, unit trusts, stock brokers, listed public companies, margin traders, underwriters, investment managers, credit rating agencies and securities depositories.

Foreign investors can purchase up to 100% of equity in Sri Lankan companies in numerous permitted sectors. In order to facilitate

portfolio investments, country funds and regional funds may obtain Ministry of Finance approval to invest in Sri Lanka's stock market. These funds make transactions through share investment external Rupee accounts maintained in commercial banks.

#### --Colombo Stock Exchange

The Colombo Stock Exchange (CSE), while small by "big emerging market" standards, is one of the most technologically sophisticated in the region. The CSE has fully automated trading, clearing and settlement systems. The CSE has a rolling settlement period of 3 days. Fifteen local and foreign joint venture brokers currently operate at the CSE. Foreign stockbrokers are permitted to hold up to 100% equity in stock brokerage firms operating at the CSE. The SEC has a settlement guarantee fund with an initial capital of Rs 100 million (\$93,000), which aims to guarantee the settlement of trades between clearing members of the exchange.

There are 235 companies listed on the stock exchange with the top ten positions by market capitalization held by telecommunication companies, banks, conglomerates and food and beverage companies. The CSE, after being one of the best performing markets in the region in 2005-6, suffered due to increased conflict-related violence in 2007, declining by about 7%. While the market is sensitive to the security situation, strong corporate performance and sometimes negative real interest rates have encouraged stock purchases in an environment with few other attractive opportunities.

Stock market development, though progressing, has been slowed by the long term impact of the civil war on investor confidence. Other issues include lack of liquidity and limited market size. Improvements are also needed in corporate governance, accountability, and public disclosure. The Accounting and Auditing Standards Monitoring Board, the Ceylon Chamber of Commerce, the Colombo Stock Exchange, and professional accounting bodies are taking initiatives in these areas.

Acquisition of companies through mergers and acquisitions is governed by the Takeovers and Mergers Code of 1995 made under the Securities and Exchange Commission of Sri Lanka Act. This law applies only to companies listed on the Colombo Stock Exchange. It is modeled on the lines of the London City Code on Takeovers and Mergers. Acquisition of more than a 30% stake of a listed company requires the buyer to make an offer to all other shareholders. The articles of association of a few listed companies restrict foreign equity to certain levels.

#### --Banking System

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Sri Lanka has a fairly well diversified banking system. There are 23 commercial banks - eleven local and twelve foreign. In addition, there are thirteen local specialized banks. Citibank NA is the only U.S. bank operating in Sri Lanka. ICICI Bank of India is the newest foreign bank in Sri Lanka; it commenced operations in January 2006. In 2001-2003, Mashreq Bank, American Express Bank, Nova Scotia Bank and ABN Amro Bank all sold their banking operations in Colombo to existing banks. Sri Lanka experienced its first bank failure in December 2002 when the Central Bank took action to revoke the license of a small licensed specialized bank as it approached insolvency. There was no fallout for other banks from this incident. Two other small troubled banks were restructured under Central Bank guidance.

The Central Bank is responsible for supervision of all banking institutions. It has driven improvements in banking regulations, provisioning, and public disclosure of banking sector performance. Since 2004, credit ratings have been mandatory for all banks operating in Sri Lanka. In 2006, the Central Bank introduced higher capital requirements for commercial banks to further stabilize the banking system, promote consolidation, and facilitate entry of larger banks. In January 2008, the Central Bank issued corporate governance rules for banks. The new rules are aimed at promoting the safety and soundness of the banking system. Nevertheless, the

Central Bank still suffers from lack of autonomous authority, especially with regard to the large state owned banks.

Sri Lanka has enacted laws to deal with money laundering and terrorist financing. The Bank Supervision Department of the Central Bank supervises and examines financial institutions for compliance with anti-money laundering and terrorist financing regulations. A Financial Intelligence Unit (FIU) was created in 2006 and has authority to establish requirements and issue instructions to banks regarding these anti-money laundering and terrorist financing regulations.

#### State-Owned Banks

Total assets of commercial banks stood at Rs 1,771 billion (\$17 billion) as of December 31, 2006. The two state-owned commercial banks, Bank of Ceylon and People's Bank, with assets of Rs 378 billion (\$3.6 billion) and Rs 339 billion (\$3.2 billion) respectively, still dominate banking, accounting for about 40% of all assets.

The two state banks are inefficient and have accumulated extensive bad debt. However, as these banks are implicitly guaranteed by the state, their problems have not harmed the credibility of the rest of the banking system. Progress has been made in restructuring the two banks - their nonperforming loan ratios have declined from 18% in 2003 to 5-7% in 2006, while provisioning and profitability have improved. Capital adequacy ratios have also improved. However, fast credit growth (especially to the government and state-owned Ceylon Electricity Board and Ceylon Petroleum Corporation) and directed lending to some sectors have once again raised concerns about credit quality.

#### Private Commercial Banks and Foreign Banks

Private commercial banks and foreign banks operating in Sri Lanka generally follow more prudent credit policies and, as a group, are in better financial shape. The average rate of non performing loans to total loans in domestic private banks was 8.5% and in foreign banks was 2.0% in 2005. According to the World Bank, the banks continue to make high provisions for the nonperforming loans and risk management of the banks has significantly improved. Foreign banks tend to make provisions in line with international best practices, as most foreign bank branches are subject to host country supervision in addition to that of the Central Bank of Sri Lanka. There are concerns regarding credit acceleration in the housing and consumer sectors. The banking system could also become vulnerable to credit and liquidity risk due to a sharp rise in the ratio of credit to deposits.

#### Capital Adequacy

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Sri Lanka adopted capital adequacy standards set by the Basel Committee on banking regulations and supervisory practices in 1993. The minimum capital adequacy ratio required by the Central Bank is 5% for core capital (Tier I) and 10% for risk weighted assets (Tier I and Tier II). The Central Bank has decided to adopt Basel II standards for all banks in 2008.

Risk-based capital adequacy in the banking sector was 11.9% in 2006. The Bank of Ceylon's capital adequacy ratio has increased to 12 percent. People's Bank currently does not meet capital adequacy requirements, but it has a Ministry of Finance guarantee for funds required to meet its obligations. The government has commenced a recapitalization program at the People's Bank to enable the bank to meet its minimum capital requirements.

#### POLITICAL VIOLENCE

In 2006, fighting between the ethnic separatist Liberation Tigers of Tamil Eelam (LTTE) and the Sri Lankan military intensified in northern and eastern Sri Lanka; other parts of the country, including Colombo, suffered sporadic terrorist attacks. In 2007, fighting escalated further, including the first-ever LTTE air



attacks -- one against a military base that adjoins the international airport north of Colombo, another on oil storage facilities outside Colombo. In July 2007, following heavy fighting, the government regained control of the East from the LTTE. Targeted attacks by LTTE against politicians -- and on one occasion against civilians in a crowded shopping area -- continued in Colombo.

Prior to 2006, LTTE terrorist activities had declined after the LTTE and the government signed a formal open-ended Cease-Fire Agreement in February 2002. Between 2002 and 2005, there was a marked improvement in the business climate due to the relatively peaceful atmosphere prevailing in the country.

In 1997, the United States designated the LTTE as a Foreign Terrorist Organization (FTO). In 2007, the United States froze the assets of and blocked transactions with the Tamils Rehabilitation Organisation (TRO), a U.S.-registered non-profit group, on the grounds that it provided support for the LTTE. During two decades of war, tourists and foreign business representatives have not been terrorist targets, but they have been injured in attacks on other targets. In 2001, the LTTE attacked Colombo's international airport and destroyed commercial and military aircraft. Several military personnel were killed in the attack, airport employees were injured, and Sri Lankan civilians were caught in the crossfire. Sri Lankan Airlines, jointly owned by the Government of Sri Lanka and Emirates Airlines of Dubai, lost several commercial aircraft in the attack. The LTTE prior to 2001 attacked several foreign-flagged commercial ships in the waters off the north and east of the country. In response to these attacks, insurers imposed war risk insurance surcharges on aircraft and ships using Sri Lankan seaports and airports. These surcharges have been lifted since the cease-fire went into effect. The LTTE has also in the past bombed Colombo's financial and business districts, causing numerous casualties and extensive damage to property.

#### CORRUPTION

Sri Lanka has generally adequate laws and regulations to combat corruption, but they are unevenly enforced. U.S. firms identify corruption as a constraint on foreign investment, but, by and large, it is not a major threat to operating in Sri Lanka -- at least once a contract has been won. Corruption appears to have the greatest effect on investors in large projects and on those pursuing government procurement contracts.

There is a consensus that corruption is increasing in Sri Lanka. Both the Transparency International Corruption Perception and the World Bank's Control of Corruption indices for Sri Lanka show a decline in recent years. The World Bank Control of Corruption Index has shown a decline from -0.17 in 2004 to -0.30 in 2005, with a minimal improvement to -0.29 in 2006. Transparency International's Corruption Perception Index shows a decline from 67th place in 2004

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to 84th in the 2006 ranking. During the 2006 USAID Democracy and Governance assessment, anecdotal evidence from the private sector indicated that the percentage of a public sector contract paid in bribes nearly tripled. According to Transparency International, corruption is perceived as most pervasive in political appointments to government institutions and in government procurement awards, as well as in high frequency/low value transactions. The police force and the judiciary are perceived to be the most corrupt public institutions. Corruption is also a persistent problem in customs clearance and enables wide smuggling of certain consumer items, to the detriment of legitimate manufacturers and importers.

In January 2007, a parliamentary commission found evidence of serious and widespread waste, fraud, and abuse in the management of Sri Lanka's numerous government enterprises. Privatization of a handful of government enterprises between 2001 and 2004 also appears to have been done in a corrupt manner. The mismanagement and corruption reviewed by the Commission have cost Sri Lanka an estimated USD 1.3 billion. However, the government has taken little concrete action to date to address the commission's findings. Following the commission's report, several other large scale corruption incidents and frauds materialized, including at the

government's tax office.

Sri Lanka ratified the UN Anti-corruption Convention in 2004. Sri Lanka has signed but not ratified the UN Convention against Transnational Organized Crime. Sri Lanka became a signatory to the OECD-ADB Anti-Corruption Regional Plan in May 2006.

--Bribery Commission is not effective.

The Bribery Commission is the main body responsible for investigating allegations of bribery and corruption. The function of the Commission, under Act No 19 of 1994, is to investigate allegations brought to its attention and to institute proceedings against responsible individuals in the appropriate court. The law states that a public official's offer or acceptance of a bribe constitutes a criminal offense and carries a maximum sentence of seven years imprisonment and a fine at the discretion of the courts. A bribe by a local company to a foreign official is not covered by the Bribery Act.

Several other government entities try to address corruption, the most important being the Auditor General's Department and the National Procurement Agency. However, there is a confusion of mandates and these institutions frequently interpret their mandates narrowly, inhibiting their effectiveness. Few Sri Lankans have been found guilty of corruption in recent years. Although highly publicized, efforts to investigate bribery and corruption have failed, damaging public confidence in such processes. While corruption charges have been leveled against politicians and top officials in charge of key government corporations, none of the accused has been convicted.

BILATERAL INVESTMENT AGREEMENTS

The Government of Sri Lanka has signed investment protection agreements with the United States (which came into force in May 1993) and with the following countries:

1. Belgium
2. People's Republic of China
3. Denmark
4. Egypt
5. Finland
6. France
7. Germany
8. Indonesia
9. India
10. Iran
11. Italy
12. Japan
13. Korea
14. Luxembourg
15. Malaysia
16. Netherlands

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17. Norway
18. Romania
19. Singapore
20. Sweden
21. Switzerland
22. Thailand
23. United Kingdom

--Taxation

A bilateral treaty between Sri Lanka and the United States to avoid double taxation was ratified and entered into force on June 12, 2004.

Foreign investors not qualifying for Board of Investment incentives such as tax and exchange control exemptions or concessions are liable to pay taxes on corporate profits, dividends, and remittances of profits. They are also liable to pay a Value Added Tax on goods and services. The government has also imposed a tax of 0.1% on debits to any current or savings account maintained at any bank in Sri Lanka. Debits made to accounts of government and international

organizations are excluded. Accounts maintained at Foreign Currency Banking Units, accounts maintained for stock exchange transactions (SIERA), and resident and non-resident foreign currency accounts are exempted from the tax. The Embassy encourages prospective U.S. investors to contact an international auditing firm operating in Sri Lanka to assess their tax liability.

#### OPIC AND OTHER INVESTMENT INSURANCE PROGRAMS

The United States and Sri Lanka concluded in 1966 (and renewed in 1993) an agreement that allows the Overseas Private Investment Corporation (OPIC) to provide investment insurance guarantees for U.S. investors. OPIC currently provides coverage to banking and power sector investments in Sri Lanka. Sri Lanka's membership in the Multilateral Investment Guarantee Agency (MIGA) offers the opportunity for insurance against non-commercial risks.

The U.S. Embassy and other U.S. Government institutions spend over \$15 million annually in Sri Lanka. This amount can potentially be utilized by OPIC to honor an inconvertibility claim; however, no such claims have been made to date in Sri Lanka. The Embassy purchases local currency at the financial rate.

#### LABOR

##### --Labor Force

Sri Lanka's labor force is literate (particularly in local languages) and trainable, although weak in certain technical skills and the English language. The average worker has eight years of schooling. Two thirds of the labor force is male. The unemployment rate has declined in recent years to around 6.5%. The rate of unemployment among women and high school and college graduates, however, has been proportionally higher than the rate for less-educated workers. Youth and entry-level unemployment and underemployment remain a problem. A significant proportion of unemployed people seek "white collar" jobs. However, most sectors seeking employees offer manual or semi-skilled jobs or require technical or professional skills such as management, marketing, information technology, accountancy and finance, and English language proficiency. The construction, plantation and apparel industries report a shortage of workers. Some investors have faced problems in finding sufficient employees with the requisite skills.

The government has initiated educational reforms it hopes will lead to better preparation of students and better matches between graduates and jobs. More computer, accounting and business skills training programs and English language programs are becoming available. But the demand for these skills still outpaces supply.

##### --Migrant Workers Abroad

There are an estimated 1.5 million Sri Lankan workers abroad.

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Remittances from migrant workers, at around \$2.7 billion, are one of Sri Lanka's largest sources of foreign exchange. The majority of this labor force is unskilled (housemaids and factory laborers) and located primarily in the Middle East, but Sri Lanka is also losing many of its technically and professionally qualified workers to more lucrative jobs abroad.

##### --Wages and Holidays

Labor is available at relatively low cost, though it is priced higher than in some other South Asian countries. Productivity lags behind other countries in Asia. Child labor is prohibited and is virtually nonexistent in the organized sector, although child labor occurs in informal sectors. The minimum legal age for employment is set at 14. Most permanent full-time workers are covered by laws pertaining to maximum hours of work, minimum wage, leave, the right of association, and safety and health standards.

There is widespread belief that Sri Lanka's labor laws and its numerous official holidays dampen productivity. The full moon day

of each month (sacred in the Buddhist faith), if it falls on a weekday, is a paid holiday. There are also eight other public holidays. The public sector and banks enjoy additional holidays. These statutory holidays are in addition to 21 days of annual/casual leave and approximately 21 days of sick leave (the number of days for sick leave is at the discretion of the management). Further, female employees are entitled to 84 days fully paid maternity leave for the first two pregnancies. Female workers are permitted 60 hours of overtime work per month.

The Government continues to interfere with private sector wage setting. In October 2005 the Government, through an act of Parliament, took steps to mandate a wage increase (of approximately Rs 1,000 per month) to private sector workers. The private sector is concerned about such interference in wage setting, which could damage competitiveness in certain sectors.

#### --Termination Laws

The Termination of Employment of Workmen Act (TEA) makes it difficult to fire or lay off workers who have been employed more than six months for any reason other than serious, well-documented disciplinary problems. Disputes over dismissals can be brought to a labor tribunal administered by the Ministry of Justice. The labor tribunals have large backlogs of unresolved cases. Certain labor disputes founded upon fundamental rights (allegations of termination/transfers based upon discrimination, etc.) can be brought directly to the Supreme Court.

The government has introduced a standard compensation formula under the TEA to facilitate termination. Recent amendments to the Industrial Disputes Act (IDA) include labor dispute resolution rules to expedite the dispute process.

The compensation formula takes into account the number of years of service and offers 2.5 months salary as compensation for 1 year of service, 12.5 months salary for 5 years of service; 38 months for 20 years and up to a maximum of 48 months salary for 34 years service. This assumes that the government will approve such a termination, which frequently is not the case. The proposed unemployment benefit insurance scheme to provide an additional payment has not yet come into effect. According to a recent IMF report, Sri Lanka's firing cost for 20 years of service, at 38 months, is among the highest in Asia compared with Pakistan and Nepal's 22.5 months, India's 19.6 months, Malaysia's 18.5 months, China's 13.2 months and Bangladesh's 11.7 months. The Labor Commissioner's approval or the affected employee's consent is required to fire workers. Employers complain that the package is excessive, especially compared to international norms. They have also pointed out that higher compensation could adversely affect companies requiring restructuring, and discourage investment.

#### --Trade Unions

About 20% of the 6.8 million-strong work force is unionized, but

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union membership is declining. There are more than 1,650 registered trade unions (many of which have 50 or fewer members), and 19 federations. About 15% of labor in the industry and service sector is unionized. Most of the major trade unions are affiliated with political parties, creating a highly politicized labor environment. Several trade unions with affiliations to major political parties have formed themselves into an organized group, the National Association for Trade Union Research and Education (NATURE), to promote education and training among trade unionists.

All workers, other than police, armed forces, prison service, and those in essential services, have the right to strike. By law, workers may lodge complaints to protect their rights with the commissioner of labor, a labor tribunal, or the Supreme Court. The president retains the power to designate any industry as an essential service.

Unions represented workers in many large private firms, but workers in small-scale agriculture and small businesses usually did not

belong to unions. Public sector employees were unionized at very high rates. Labor in export processing zone enterprises tends to be represented by non-union worker councils.

Unions have complained that the Board of Investment and some employers, especially in the BOI-run export processing zones, prohibit union access and do not register unions on a timely basis. Employers allege that the JVP, a Marxist political party opposed to private enterprise, could provoke labor to strike under the pretense of trade union activity. Due to the JVP's violent past, employers are generally not in favor of it or its trade union arm, the Inter-Company Trade Union.

In BOI enterprises, including those in the export processing zones, worker councils composed of employees generally engage in labor and management negotiations. These worker councils have functioned well in some companies in providing for worker welfare. The BOI has requested that companies recognize trade unions and accept the right to collective bargaining. According to the BOI, where both a recognized trade union with bargaining power and a non-union worker council exist in an enterprise, the trade union will represent the employees in collective bargaining.

The International Labor Organization's (ILO) Freedom of Association Committee has observed that Sri Lankan trade unions and employee councils can co-exist, but advises that there should not be any discrimination against those employees choosing to join a union. The right of employee councils to engage in collective bargaining has been held as valid by the ILO. The ILO has, however, noted weaknesses in rules governing operation of employee councils and low prevalence of collective bargaining agreements and requested that the Government address these issues.

In response to these observations, the BOI revised its labor manual in March 2004, requesting that companies located in export processing zones allow union access to zones and provide official time off to union members to attend meetings. Along with this revision, the BOI also issued new guidelines for the formation and operation of employee councils, giving powers to employee councils to negotiate binding collective agreements.

In 2002, the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) submitted a petition to the United States Trade Representative seeking suspension of Generalized System of Preferences (GSP) benefits for Sri Lanka due to labor rights violations in some factories in the export processing zones. USTR did not act on this petition. A Sri Lanka trade union made a similar case with the European Union (EU) when Sri Lanka applied for benefits under the special incentive arrangements of the GSP. After an audit, the EU, in January 2004, granted significant benefits to Sri Lanka under EU GSP in recognition of the country's efforts to implement core labor standards. The EU, however, urged improvements in freedom of association.

Key public sector entities such as the Ceylon Electricity Board and the Sri Lanka Ports Authority also have large unions which have

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protested anticipated moves towards privatization or restructuring. In July 2006, the Supreme Court broke a port slowdown which had disrupted shipping through the Colombo Port for over a week. However, in response to a challenge lodged by several unions, the ILO Freedom of Association Committee noted that the port "go-slow" action did not disrupt an essential service, i.e. one whose disruption would endanger life, personal safety or health of the whole or part of the population.

#### --Collective Bargaining

Collective bargaining is not yet popular. While about half of the 500 members of the Employers' Federation of Ceylon is unionized, currently only about 44 of these companies (including a number of foreign-owned firms) have collective agreements and use them to conduct negotiations on their behalf.

#### --Labor-Management Relations

Formerly confrontational labor-management relations have improved in the last few years as employers have worked harder to motivate and care for workers. Work stoppages and strikes in the private sector are on the decline. While labor-management relations vary from organization to organization, managers who emphasize communication with workers and offer training opportunities generally experience fewer difficulties. U.S. investors in Sri Lanka (including U.S. garment buyers) generally promote good labor management relations and labor conditions that exceed local standards.

#### --ILO conventions

Sri Lanka is a member of the International Labor Organization (ILO) and has ratified 31 international labor conventions. The labor laws of Sri Lanka are laid out in almost 50 different statutes. The Ministry of Labor has published a Labor Code, consolidating important labor legislation. Sri Lanka has ratified all eight of the core labor conventions included in the 1998 ILO Declaration on Fundamental Principles and Rights at Work. ILO Convention 138 on minimum age for admission to employment and Convention 182 on worst forms of child labor were ratified during 2000-2001. Sri Lanka ratified ILO convention 105 on Forced Labor in 2003. The ILO and the Employers' Federation of Ceylon are working to improve awareness of core labor standards. The ILO also promotes its Decent Work Agenda program in Sri Lanka.

#### FOREIGN TRADE ZONES/FREE PORTS

Sri Lanka has 12 free trade zones, also called export-processing zones, administered by the BOI. The oldest, the Katunayake and Biyagama Zones, located north of Colombo near the Bandaranaike International Airport, are fully occupied. The third zone is located at Koggala on the southern coast. Several new mini export-processing zones were opened in the provinces during the last few years. There are nearly 200 foreign export processing enterprises operating in these zones. There are also two industrial parks that have both export-oriented and non-export oriented factories. They are located in Pallekelle, near Kandy in central Sri Lanka, and in Seethawaka in Avissawela about 60 kilometers from Colombo. In addition, a large private apparel company recently opened Sri Lanka's first privately run fabric park. The company invites local and foreign companies to set up fabric and apparel factories in this eco-friendly park.

In the past, firms preferred to locate their factories near Colombo harbor or airport to reduce transport time and cost. However, excessive concentration of industries around Colombo has caused heavy traffic, higher real estate prices, environmental pollution, and scarcity of labor. The BOI and the government now encourage export-oriented factories to set up in industrial zones farther from Colombo. However, Sri Lanka's poor roads make these outlying zones less appealing.

#### FOREIGN DIRECT INVESTMENT STATISTICS

##### --Investment Trends

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From 1998-2001, foreign direct investment (FDI) flows to Sri Lanka averaged only about \$150 million per year (excluding privatization receipts). Since the 2002 ceasefire improved investor confidence, annual Foreign Direct Investment (FDI) has averaged about \$200 million. In 2006, FDI increased to about \$450 million. FDI is expected to total \$550 million in 2007, centered on telecommunications, business process outsourcing, and hotel and restaurant services.

##### --U.S. Investments

Total cumulative U.S. investment in Sri Lanka is estimated to be in the range of \$200 million. Major U.S. investors include: Energizer Battery, Mast Industries, Smart Shirts (a subsidiary of Kellwood Industries), Chevron, Citibank, Caterpillar, 3M, Coca Cola, Tandon Corporation, Paxar Corporation, Pepsi Co, Sportif, Worldquest, Fitch

IBCR, AES Corporation, American International Group (AIG), American Premium Water, Virtusa, Avery Denison, North Sails, Amsafe Bridport, and RR Donnelly (through Office Tiger). Several Sri Lankan-Americans have started IT and BPO companies in Sri Lanka serving the US market. In addition, IBM, Lanier, NCR, GTE, Motorola, Procter & Gamble, Liz Claiborne, Tommy Hilfiger, J.C. Penney, Sun Microsystems, Microsoft, Bates Strategic Alliance, McCann-Erickson, Pricewaterhouse Coopers, Ernst and Young, and KPMG all have branches, affiliated offices or local distributors/representatives. Kentucky Fried Chicken, Pizza Hut, Federal Express, UPS, and McDonald's are represented in Sri Lanka through franchises. Numerous other American brands and products are represented by local agents.

#### --Non-U.S. Investments

Leading sources of foreign direct investment in Sri Lanka are Malaysia, the United Kingdom, the United States, Singapore, India, China, the UAE, and Korea. Major non-U.S. investors include: Unilever, Nestle, British American Tobacco Company, Mitsui, Pacific Dunlop/Ansell, Prima, FDK, Telekom Malaysia Bhd, S.P. Tao, HSBC and the Indian Oil Corporation. Leading U.S. and foreign investors that have acquired significant stakes in privatized companies include Chevron, Norsk Hydro of Norway, Hanjung Steel of Korea, Nippon Telephone and Telegraph, Mitsubishi Corporation and C. Itoh (A.K.A. Itochu) of Japan, Emirates Airlines of United Arab Emirates, Shell Oil of the UK, P&O Netherlands, and the Indian Oil Corporation.

#### Web Resources:

Board of Investment of Sri Lanka: [www.boi.lk](http://www.boi.lk)

International Monetary Fund (IMF) Sri Lanka country information:  
[www.imf.org/external/country/LKA/index.htm](http://www.imf.org/external/country/LKA/index.htm)

Article VIII obligations of the International Monetary Fund:  
[www.imf.org/external/pubs/ft/aa/aa08.htm](http://www.imf.org/external/pubs/ft/aa/aa08.htm)

U.S.-Sri Lanka Bilateral Investment Treaty:  
[www.state.gov/documents/organization/43588.pdf](http://www.state.gov/documents/organization/43588.pdf)

Institute for the Development of Commercial Law and Practice:  
[www.iclparbitrationcentre.com](http://www.iclparbitrationcentre.com)

Indo-Lanka Free Trade Agreement: [www.doc.gov.lk](http://www.doc.gov.lk)

South Asian Free Trade Area: [www.saarc-sec.org/main.php](http://www.saarc-sec.org/main.php)

Fitch Ratings Lanka: [www.fitchratings.lk](http://www.fitchratings.lk)

Development Assistance Database: [www.dad.tafren.gov.lk](http://www.dad.tafren.gov.lk)

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